No. 7198

In the

United States
Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

Fifth Street Building, a corporation,
Petitioner,

vs.

Commissioner of Internal Revenue,
Respondent.

BRIEF OF PETITIONER.

THOMAS R. DEMPSEY,
A. CALDER MACKAY,
1104 Pacific Mutual Building, Los Angeles, California,
Attorneys for Petitioner.

EDWARD S. BRASHEARS,
316 Investment Building, Washington, D. C.,

CLARK J. MILLIRON,
GEORGE H. P. SHAW,
518 Fidelity Building, Los Angeles, California,
Of Counsel for Petitioner.

Parker, Stone & Baird Co., Law Printers, Los Angeles.

TOPICAL INDEX.

TABLE OF AUTHORITIES CITED.

CASES. PAGE

TEXT BOOKS AND ENCYCLOPEDIAS.

INDEX TO APPENDIX.

PAGE

No. 7198

In the

United States
Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

Fifth Street Building, a corporation,
Petitioner,

vs.

Commissioner of Internal Revenue,
Respondent.

BRIEF OF PETITIONER.

HISTORY AND PREVIOUS OPINION.

The Commissioner of Internal Revenue, Respondent herein, on April 19, 1926, mailed to Petitioner, sometimes hereinafter referred to as Taxpayer, a letter proposing an additional tax for the year 1921 in the sum of $19,684.69. [R. p. 28.] Within the sixty day period provided by law Petitioner filed a petition with the United States Board of Tax Appeals. On July 10, 1929, the Respondent, by letter, proposed an additional tax against Petitioner for the year 1926 in the sum of $1,142.72 and thereafter and within the period allowed by law an appeal was filed by Petitioner with the United States Board of Tax Appeals.

[R. p. 43.] These two appeals were consolidated by the Board of Tax Appeals for hearing and decision and an order has been made by this Honorable Court for consolidation. [R. p. 48.]

Petitioner was incorporated under the laws of the State of California on March 30, 1921, and on May 18, 1921, in exchange for substantially all of its stock, it acquired from Clark J. Milliron a contract for lease dated November 1, 1920. [R. p. 50.] The contract for lease was made by Gladys Billicke and A. B. C. Dohrmann, as first parties, and W. A. Faris and R. M. Walker, as second parties. [R. pp. 50-53.] W. A. Faris and R. M. Walker, on November 2, 1920, made a gift to C. J. Milliron in writing of all their right, title and interest in the lease agreement. [R. pp. 53, 54.] Petitioner offered evidence, which was uncontradicted, proving the contract for lease had a value on November 2, 1920, at the time he received it as a gift, of $640,000.00 which was also its value on January 1, 1921, and May 18, 1921. Petitioner contended that the sum of $640,000.00 should be included in its invested capital for the year 1921 and that this value should also be used as its basis for determining its deduction for depreciation and amortization. The Respondent contended that the contract for lease obtained by the corporation was acquired by Mr. Milliron on January 1, 1921, instead of November 2, 1920; it had cost Mr. Milliron nothing and that, therefore, no part of the said sum of $640,000.00 should be included in Petitioner's invested capital for the year 1921; Respondent further contended that this sum did not constitute the basis for the determination of depreciation or amortization.

The United States Board of Tax Appeals held that the transaction whereby Clark J. Milliron acquired said contract for lease was not a gift and inasmuch it had cost him nothing that no part of the value on November 2, 1920 of said contract for lease constituted Petitioner's invested capital. The Board of Tax Appeals, however, held that Petitioner for the year 1921 was entitled to compute its deductions for depreciation or amortization of its contract for lease on the basis of its fair market value, which the Board found to be $640,000.00 on January 1, 1921, and May 20, 1921, but the Board held that this sum should not be the basis for such deductions for the year 1926. [R. pp. 106-113.]

After the promulgation of the Board's opinion, but prior to the entry or rendition of judgment, the Respondent filed a motion with the Board wherein he requested the Board to allow depreciation on the contract for lease only from the date of its acquisition by Petitioner, to wit, May 18, 1921 [R. pp. 79-88], whereupon Petitioner filed a motion requesting the Board to exclude from Petitioner's net taxable income the amount of rentals accruing on said contract for lease for the period from January 1, 1921 to May 17, 1921, inclusive, the period prior to the time of the acquisition thereof by Petitioner. [R. pp. 91-103.] The Board of Tax Appeals denied the motion of the Respondent as well as the motion of Petitioner and held that Petitioner was entitled to take depreciation for the full year 1921, and that the rentals paid to and received by C. J. Milliron prior to the acquisition by Petitioner of said contract for lease constituted income of the Petitioner. [R. pp. 105-106.]

Jurisdiction.

Fifth Street Building was and is a corporation organized under and by virtue of the laws of the State of California and during the years herein involved filed its income tax returns with the Collector of Internal Revenue for the Sixth Collection District of California. [R. pp. 6, 36.]

The decision of the United States Board of Tax Appeals was entered on March 16, 1932. [R. p. 114.] Petitioner filed its petitions for review by this Honorable Court with the Clerk of the United States Board of Tax Appeals on September 13, 1932. [R. pp. 126, 135.] These appeals were taken pursuant to the provisions of Sections 1001, 1002, and 1003 of the Act of Congress approved February 26, 1926, entitled the "Revenue Act of 1926" (44 Stat. 1, 109, 110; U. S. C. A., Sections 1224, 1225, 1226), as amended by Section 603 of the Act of Congress approved May 29, 1928, entitled "The Revenue Act of 1928" (45 Stat. 873).

QUESTIONS PRESENTED.

I.

Is Petitioner entitled to include in its invested capital for the year 1921 the sum of $640,000.00 representing the value of the contract for lease acquired by it from C. J. Milliron in exchange for substantially all of its stock?

II.

Is Petitioner entitled to use as its basis for determining its deduction for amortization and depreciation of its leasehold interests for the year 1926 the sum of $640,000.00?

III.

Do the rentals received by C. J. Milliron from January 2, 1921 to May 18, 1921, constitute taxable income to Petitioner, Petitioner having acquired the lease on May 18, 1921?

Statutes Involved.

See Appendix pages 37 to 41.

STATEMENT OF FACTS.

Petitioner was incorporated under the laws of the State of California on March 30, 1921, and on May 18, 1921, in exchange for substantially all of its stock, it acquired from Clark J. Milliron a contract for lease dated November 1, 1920. [R. p. 56.] This latter contract was made with Gladys Billicke and A. B. C. Dohrmann, as first parties, and W. A. Faris and R. M. Walker, as second parties, and provided, among other things, that the first parties would organize a corporation and transfer certain properties to it and that they would cause said corporation to make a 99 year lease on the premises covered by said contract for lease to a corporation to be organized by second parties. All the terms, covenants, and conditions of the 99 year lease were set forth in a copy attached to and made a part of said contract. W. A. Faris and R. M. Walker, parties of the second part, also agreed to execute, at the time of the signing of the lease (a copy of which was attached to the agreement) a guarantee, a copy of which was attached, by which they guaranteed the faithful performance by the lessee, of the lease covenants until the building therein specified should be erected. [R. p. 191.]

On said November 1, 1920, W. A. Faris and R. M. Walker, by an instrument in writing, executed coincident with and on the same document and as part of said contract for lease, agreed to pay the sum of $30,000.00 on December 31, 1920, as a consideration for the cancellation of the then existing lease on the property covered by the above mentioned contract for lease dated November 1, 1920. [R. p. 195.]

On November 2, 1920, C. J. Milliron received as a gift from W. A. Faris and R. M. Walker all of their right,

title, and interest in said agreement, Mr. Milliron assuming their duties and obligations imposed by said contract of November 1, 1920. [R. pp. 202-203.] Prior to the incorporation of Petitioner as provided for in the aforesaid contract for lease and the transfer to Petitioner of the agreement of lease and on January 2, 1921, said C. J. Milliron, as lessor, executed a certain indenture of lease to Faris-Walker, a copartnership doing business under the name of "Fifth Street Store", as lessee, of the premises described in the lease attached to said lease agreement, for one year from the 1st day of January, 1921, and for such longer term as might be agreed upon between the parties, at the annual rental of $150,000.00, payable in advance in twelve (12) equal monthly installments of $12,500.00, commencing on January 1, 1921, which monthly installments were paid when due. [R. pp. 207-210.]

On December 31, 1920, said $30,000.00 was paid by Faris-Walker and a receipt was delivered showing the cancellation as of that date of the then existing leases which had been entered into on December 27, 1911, on the property. [R. p. 165.]

The 99 year lease referred to in said contract of November 1, 1920, was executed by the two newly formed corporations on May 20, 1921, and on said date W. A. Faris and R. M. Walker signed the guarantee for the faithful performance of the lease contract until the building therein specified should be erected. [R. pp. 180, 181, 206, 207.]

The contract for lease dated November 1, 1920 had a value on November 2, 1920 of $640,000.00 [R. pp. 143, 156, 162]; its value on January, 2, 1921, and also on May 18, 1921, was $640,000.00. [R. pp. 58, 117.]

Assignments of Error Relied Upon.

Petitioner relied upon all the assignments of error set forth in its petitions for review [R. pp. 122, 123, 124, 132, 133, 134] which may be consolidated as follows:

1. The Board of Tax Appeals erred in including in Petitioner's net taxable income for the year 1921, any portion of the rent from January 1, 1921 to May 17, 1921, which had accrued and had been received by C. J. Milliron, as lessor, from Faris-Walker, a copartnership, as lessee under the terms of that certain lease dated January 2, 1921.

2. The Board of Tax Appeals erred in denying Petitioner's motion made on or about March 5, 1932, to amend its petition setting forth that the Respondent erroneously included and/or failed to eliminate from Petitioner's net taxable income for the year 1921 rentals paid by Faris and Walker to and received by Clark J. Milliron pursuant to the lease dated January 2, 1921, for the period from January 1, 1921 to May 17, 1921, inclusive, and in refusing to reopen said case to permit, by stipulation or proof, the introduction of facts showing the erroneous inclusion of said sum which does not constitute taxable income to Petitioner for the year 1921.

3. The Board of Tax Appeals erred in failing to include, as part of Petitioner's invested capital, the sum of $56,854.91 received by Petitioner from C. J. Milliron, which amount was paid by Faris and Walker and received by Milliron as rental prior to the transfer of the contract November 1, 1920 to the Petitioner, and in refusing to reopen said case to permit, by stipulation or proof, the introduction of facts showing said error.

4. The Board of Tax Appeals erred in failing to include in Petitioner's invested capital for the year 1921 the additional sum of $640,000.00 representing the cost to Petitioner of certain leasehold rights.

5. The Board of Tax Appeals erred in failing to hold that the cost basis of Petitioner's leasehold interest was $640,000.00.

6. The Board of Tax Appeals erred in failing to hold that Clark J. Milliron on November 2, 1920, received as a gift the leasehold interest transferred to and acquired by Petitioner on May 18, 1921, in exchange for its stock and that said leasehold interest at the time acquired by said Clark J. Milliron on said November 2, 1920 had a value of $640,000.00.

7. The Board of Tax Appeals erred in failing to find a value of $640,000.00 for the leasehold contract on May 18, 1921.

8. The Board of Tax Appeals erred in admitting over Petitioner's objection Respondent's Exhibits A-1, A-2 and A-3.

9. The Board of Tax Appeals erred in finding that on November 1, 1920, Faris and Walker paid $30,000.00 to the estate of A. C. Billicke for the cancellation of certain leases dated December 27, 1911, and in not finding that Faris-Walker, a partnership, paid said $30,000.00 on December 31, 1920 for the cancellation of three certain leases dated December 27, 1911, between A. C. Billicke, Lessor, and Muse-Faris-Walker Company, a corporation, Lessee, under which said leases Faris-Walker, a partnership, occupied the premises until December 31, 1920.

10. The Board of Tax Appeals erred in determining a deficiency against Petitioner for the year 1921 in the sum of $16,710.96, or in any sum whatsoever.

11. The Board of Tax Appeals erred in failing to find that Petitioner had overpaid its taxes for the year 1921 and was, therefore, entitled to a refund of said overpayment.

12. The Board of Tax Appeals erred in holding that dealings between an attorney and client are presumptively invalid and in failing to find and hold that the gift of the contract of November 1, 1920 by W. A. Faris and R. M. Walker to Clark J. Milliron was a valid transaction.

13. The Board of Tax Appeals erred in holding that Petitioner, in the determination of its net taxable income for the year 1926, was not entitled to a deduction for amortization or depreciation of its leasehold rights acquired by it in exchange for its stock.

14. The Board of Tax Appeals erred in holding that Petitioner had no basis for the determination of a deduction for depreciation or amortization of its leasehold rights.

15. The Board of Tax Appeals erred in failing to hold that Petitioner was entitled, in the determination of its depreciation or amortization deductions for the year 1926, to use as the cost basis of its leasehold rights the sum of $640,000.00.

16. The Board of Tax Appeals erred in determining a deficiency against Petitioner for the year 1926 in the sum of $1,142.72, or in any sum whatsoever.

ARGUMENT.

I.

Petitioner Is Entitled to Include in Its Invested Capital for the Year 1921 the Sum of $640,000.00 Representing the Fair Market Value of the Contract for Lease.

Section 326 of the Revenue Act of 1921 [see Appendix p. 38] provides that there should be included, among other things, in the taxpayer's invested capital the actual cash value of tangible property, other than cash, *bona fide* paid in for stock or shares, at the time of such payment.

Section 331 of the same Act provides:

> "That in the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *Provided,* That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation."

The Respondent contends that the contract for lease which was acquired by the corporation on May 18, 1921, in exchange for its stock, did not cost the previous owner, Mr. Milliron, anything, and that, therefore, no part of the value of the contract for lease constitutes invested capital under the proviso contained in Section 331 above quoted. The Respondent's theory is based solely upon his contention that the acquisition of the contract for lease by Mr. Milliron from W. A. Faris and R. M. Walker was not a gift. If it was a gift, then the cost basis thereof would be its fair market value at the date acquired, which was $640,000.00.

On January 2, 1921, Clark J. Milliron, by a written instrument, leased the premises covered by the contract for lease dated November 1, 1920, to W. A. Faris and R. M. Walker, the latter agreeing to pay Mr. Milliron the sum of $150,000.00 per year, or at the rate of $12,500.00 per month. [R. p. 207.]

On May 20, 1921, the new corporation which was organized by Mr. Milliron, entered into a 99 year lease of the premises, the lease, however, taking effect from the 1st day of January, 1921. [R. p. 206.] The rentals received by Mr. Milliron under his lease from January 2, 1921 to May 20, 1921, amounted to $56,854.91. This sum and the whole thereof constitutes contributed capital; consequently, under the provisions of Section 326 of the Revenue Act of 1921 it forms a part of Petitioner's invested capital.

(a) The Acquisition by Clark J. Milliron of the Contract for Lease Turned Over to Petitioner Constituted a Gift.

The uncontradicted evidence shows that W. A. Faris and R. M. Walker, on November 2, 1920, gave to Mr. Milliron all their right, title and interest in and to that certain agreement made the 1st day of November, 1920, by and between Gladys Billicke and A. B. C. Dohrmann, as first parties, and W. A. Faris and R. M. Walker, as second parties. The instrument making the gift was dated November 2, 1920, and is in words and figures as follows [R. pp. 202, 203]:

"Faris-Walker

The 5th Street Store
Importers, Jobbers, Retailers
Merchandise

Los Angeles, Cal.
November 2nd, 1920.

Broadway & 5th Streets
Mr. C. J. Milliron
611 Trust & Savings Bldg.
City.

Dear Mr. Milliron:

In consideration of your assuming all of the duties and obligations imposed upon us by reason of our contract to execute a lease dated November 1st, 1920, between Gladys Billicke and A. B. C. Dohrmann and ourselves as second parties, a copy of which agreement is attached, we hereby give and assign to you all our right, title and interest in said agreement, it

being understood that you are to assume all of our obligations either directly or indirectly imposed as result of this agreement.

W. A. Faris
R. M. Walker"

Upon the receipt of the foregoing letter dated November 2, 1920, Mr. Milliron accepted the gift by writing a letter to W. A. Faris and R. M. Walker, a true copy of which is as follows [R. p. 203]:

"November 2nd, 1920.

W. A. Faris
&
R. M. Walker

Gentlemen:

Your gift to me today of your contract of November 1st to execute a lease on the premises generally known as the 'Billicke' properties, is hereby accepted and I agree to assume all your obligations thereunder and to hold you free and clear of any liabilities as a result thereof.

I will cause to be prepared an assignment of this contract executed in due form for the purpose of record.

Respectfully,

C. J. Milliron"

The Board found as a fact that the letters were signed and delivered on November 2, 1920. The foregoing written offer and written acceptance, it is respectfully submitted, constitute a gift.

The Board of Tax Appeals, as indicated by its opinion, was much influenced by the general rule of law that "dealings between an attorney and his client for the benefit of the former are closely scrutinized". The record discloses that Mr. Milliron was the attorney for Mr. Faris and was not the attorney for Mr. R. M. Walker. Mr. Milliron had, however, represented the partnership of Faris and Walker. [R. pp. 169 and 170.] There is nothing in the record to show that the donors, W. A. Faris and R. M. Walker, have at any time attacked the gift. Their testimony and the written documents conclusively establish the fact that they have ratified and approved the transaction. The Government, under these circumstances, has no legal or moral right to cast reflection on the transaction. In passing we wish to suggest that such an attack in any event could come only from the clients. In this connection it is important to remember that Mr. R. M. Walker was not a client of Mr. Milliron. This fact alone ought to be sufficient to establish the legitimacy of the gift. Certainly if anything had been wrong, Mr. R. M. Walker would have been the first one to have repudiated the transaction. The transaction not having been repudiated it must be recognized as a legitimate transaction.

The Respondent contends that since the instruments making the gift disclose that Mr. Milliron agreed to assume all the obligations of W. A. Faris and R. M. Walker under the contract of November 1, 1920, that there was consideration sufficient to take the transaction out of the class of a gift. We recognize that a transaction for a consideration is ordinarily not a gift, but we believe that facts in the present case fail to disclose the payment of any consideration by Mr. Milliron. Many gifts are made

where the donee assumes obligations. These obligations may be of a moral or legal nature. A gift by a parent to a child in consideration that the child will finish school has an element of not only legal but moral consideration. An educated child, of course, is less likely to be a burden on a parent than an uneducated child. Furthermore, it is not unusual for gifts to be made of equities in real property or personal property. History is replete with gifts of real property where the donee is required to keep the property up in a husbandlike manner. This requirement or obligation assumed by the donee often redounds to the donor's benefit in those cases where the donor retains adjoining properties. Many other illustrations could be given of gifts where the donee assumes obligations. The assumption of an obligation does not necessarily take the transaction out of the class of a gift.

Analyzing the facts in the case at bar in the light of history, we believe a conclusion must be arrived at that Mr. Milliron did acquire the contract for lease on November 2, 1920 as a gift. The agreement of November 1, 1920 by and between Gladys Billicke and A. B. C. Dohrmann, as first parties, and W. A. Faris and R. M. Walker, as second parties, recited that the first parties were owners of certain properties in the City of Los Angeles. The first parties agreed that they would form a corporation under the laws of the State of California, which corporation would acquire the properties of the first parties and that the corporation so organized would execute a 99 year lease to a corporation to be organized by second parties, said 99 years to commence January 1, 1921. Attached to the agreement was a full copy of the 99 year lease.

The 99 year lease required the lessee to remove buildings on the property and to erect a reinforced concrete building thereon and to pay the lessor $50,000.00 per year. W. A. Faris and R. M. Walker certainly had the right to give Mr. Milliron all of their equity in the agreement. This is just what they did, but as will be shown later they were not relieved of their obligation to guarantee the performance of the covenants of the agreement nor to pay the $30,000.00 on December 31, 1920. The value attached to the agreement was the value of Mr. Milliron's interest therein—his interest, of course, being just the interest that W. A. Faris and R. M. Walker had.

Petitioner offered testimony proving that the contract dated November 1, 1920, had a fair market value on November 2, 1920 of $640,000.00; the same witnesses testified that the fair market value of this contract on January 2, 1921 and May 18, 1921 was $640,000.00. The Board of Tax Appeals found as a fact that the contract did have a fair market value on January 2, 1921, and also on May 20, 1921 of $640,000.00, but, evidently because it did not consider it necessary under its theory, it failed to find that the contract had a value on November 2, 1920 of $640,000.00. This value will be discussed under a later heading, but it is mentioned here merely for the purpose of bringing to this Court's attention the fact that the contract did have a fair market value when acquired by Mr. Milliron on November 2, 1920. The contract for lease was worth $640,000.00 over and above the obligations assumed.

In valuing a lease, consideration must be given to the benefits and the burdens attaching thereto. If the bur-

dens are greater than the benefits, then, of course, the agreement has no fair market value. It would be worth less than nothing. On the other hand, where the benefits of an agreement exceed the burdens, then, of course, the agreement does have a fair market value. It was the value of the benefits that Mr. Milliron received as a gift. Those benefits were valued, as heretofore indicated, at the sum of $640,000.00. Certainly, that is what W. A. Faris and R. M. Walker parted with; it cannot be denied that they gave up all their right, title and interest in and to the agreement, which was worth $640,000.00—the value of the gift at that time.

It is very evident that W. A. Faris and R. M. Walker were not attempting to obtain any consideration for the benefits under the agreement. Their rights and benefits under the agreement were to go and did go to Mr. Milliron without any consideration. Certainly a parent could make a gift of a long term lease to a child without it being considered a sale even though the child—donee—did assume the obligations of the lease. Such gifts have often been made and no one has ever contended that the assumption of the obligations under the lease was consideration which would take the transaction out of the classification of a gift and place it in the classification of a sale. To hold otherwise would be to hold that no gift could be made of equities either in real or personal property unless the donor should continue making payments under the lease or contract. In substance, what passed as a gift from W. A. Faris and R. M. Walker to Mr. Milliron was a contract—property that has passed by gift since the mind of man runneth not to the contrary. It is absurd to assume that W. A. Faris and R. M. Walker (if they had

been intending to make a financial deal) would have sold their equity in the agreement for the mere assumption of the continuing liabilities when they could have obtained the sum of $640,000.00 for their equity and been relieved of their contractual obligations. Faris and Walker were not, in fact, relieved of their obligation to pay the $30,000.00 on December 31, 1920, and they did pay said sum to the lessors, and they were not relieved of their obligation to guarantee the performance of the contract to erect the building and they did sign such guarantee.

It is contended by Respondent that the language contained in the gift indicated the donors were relieved from any responsibility on their part in connection with the contract which was the subject of the gift and this constituted a valuable consideration. Construing the language, in view of the contract which was the subject of the gift, the donors were not relieved from any of their obligations. The contract obligated W. A. Faris and R. M. Walker to sign a guarantee, which was attached to the contract as Exhibit "B", whereby Faris and Walker, the donors, guaranteed that the building would be constructed and paid for in accordance with the terms of the lease. [R. pp. 195, 197.]

Therefore, they were not relieved from their obligation by the gift, and as a matter of fact actually signed the guarantee on May 20, 1921. [Stipulation, R. p. 181.]

The contract further provided that on December 31, 1920, Faris and Walker, the donors of the gift, were to pay the sum of $30,000.00 to the lessors of the property for the cancellation of the leases then existing on the premises. [R. p. 195.]

This was a part of the contract which was the subject of the gift, but the donors were in no way relieved from their obligation to make this payment, and on December 31, 1920 the $30,000.00 was actually paid by Faris and Walker, as shown by the documents offered in evidence by the Respondent. [R. p. 165.] There is nothing in the record supporting the Board's finding that Faris and Walker paid the $30,000.00 on November 1, 1920. The payment of $30,000.00 was made after the gift of the contract had been made.

Therefore, as stated above, the donors were not relieved from their obligations, and the donee, Milliron, took nothing except the contract. The words of assumption contained in the gift constitute nothing more than an acceptance of the gift and did not constitute a valuable or any other consideration.

Petitioner has no quarrel with the general rule of law that a gift is a transfer of a property without consideration. However, in determining the character of an instrument, claimed and purporting to be a gift, and also expressing a money consideration, resort must be had not only to the instrument, but also to the surrounding facts which have a tendency to determine whether or not the transaction is a gift.

> "A statement that a transfer is for value received will not alter the nature of the transaction or take away the character of a gift, when the transfer is voluntary and absolute, or where the consideration expressed is nominal *or out of all proportion to the value of the property.* (Kinnibrew v. Kinnebrew, 35 Ala. 628; Spanier v. De Voe, 52 La. Ann. 581; Harper v. Pierce, 15 La. Ann. 666; Haggerty v.

Corri, 5 La. Ann. 433; Ten Eyck v. Witbeck, 135 N. Y. 40; *In re* Lynch, 220 Pa. 14; Pearl v. Hansborough, 9 Humphrey (Tenn.), 426.)" (Italics ours.) 28 *C. J.* 624.

In *Ten Eyck v. Witbeck,* 135 N. Y. 40, the defendant's father on July 7, 1887, conveyed to his daughter (defendant herein) certain property worth $20,000.00. The deed recited a consideration of $10.00 and the annual payment to the grantor during his lifetime of the entire net proceeds of the land conveyed, and one-third of such proceeds to his wife during her liftime if she survived the grantor, and one-third of the proceeds after the death of the grantor to another daughter, and one-half of the proceeds to such daughter upon the death of both parents. The grantor in 1871 had made a prior deed of the same land to his wife, which deed was not recorded until several years after the recordation of the deed to the defendant herein.

The question presented was whether the defendant was a purchaser for value. The court stated:

> "We think it would be a perversion of language to say that a father, who had conveyed to a daughter property of the value of $20,000 for no greater sum than ten dollars paid, had sold the property to the child, or that she had bought it of him. The transfer would be recognized by the popular, as well as the judicial mind, as possessing all the essential qualities of a gift. It has been frequently so held." Citing: Hayes v. Kershow, 1 Sand. Ch. 265 ($1.00); Duvol v. Wilson, 9 Barb. 487 ($5.00); Morris v. Ward, 36 N. Y. 587 ($1.00).

* * * * * * * * *

"It is strenuously urged by counsel that the considerations expressed in defendant's deed, other than money, are sufficient to invest her with the title of a purchaser for value. * * * Unquestionably, as between the parties, the defendant, by the acceptance of the deed, became bound to observe the conditions, and render to the beneficiaries named their respective shares of the net rents and profits of the farm. *But this was simply an obligation to account for the use of the property, which was the subject of the grant, and while it might be a good consideration for the conveyance, it was in no respect a valuable consideration as that term has been judicially defined.* If, for any cause, the grant itself becomes nugatory, the covenant ceases to be operative. In order to give effect to the promise, effect must be given to the deed, and if the defendant is deprived of the land, she is relieved from the obligation which she assumed on the faith of the grant. (Dunning v. Leavitt, 85 N. Y. 30; Rice v. Goddard, 14 Pick. 293.) (Italics ours.)

* * * * * * * * *

"A valuable consideration has been defined by writers upon equity jurisprudence as something which the law esteems as an *equivalent* given for the grant, and it is, therefore, founded on motives of justice. (1 Story Eq. Juris (10th Ed.), paragraph 354.)" (Italics ours.)

In the case of *Salmon v. Wilson,* 41 Cal. 595, the father conveyed to his eight children an eight-ninths undivided interest in a large ranch in consideration of love and affection "and in the further consideration of four hundred and sixty-one dollars to him in hand paid by said parties of the second part". The deed of the gift also contained the pro-

vision that it was made subject to the payments, conditions, and agreements specified and contained in a certain indenture of mortgage. The court in this case held that by accepting the deed the grantees did not become personally liable for the mortgage debt and that the transaction was not thereby rendered a sale. The court also held that despite the money consideration mentioned in the instrument it was a gift and not a sale.

As heretofore shown, Mr. Walker and Mr. Faris were not relieved of the obligations under their contract which they gave to Mr. Milliron. They paid the $30,000.00 and executed a written instrument guaranteeing the lessors that the building would be constructed and the covenants of the lease would be performed. The action of Faris and Walker in this respect indicates that it was never their intention in making the gift to have Mr. Milliron assume these obligations. The instrument of the gift certainly could not relieve Faris and Walker of their covenants in the contract for lease. (*Cutting Packing Co. v. The Packers' Exchange of California*, 86 Cal. 574.)

The statement in the instrument, effecting the gift, of a consideration under the circumstances in this case has no more effect than the statement of considerations in the Wilson case, *supra.*

In the case of *Noe v. Card,* 14 Cal. 576, the Supreme Court of the State of California stated at page 597:

> "* * * The request made in the petition is not to purchase the lot, but that it be conceded to the petitioner, and the officer grants the favor which was requested. Both parties appear to have treated the matter as a donation—sought on the one hand and accorded on the other—not as a contract of sale and

purchase. To the grant certain conditions are attached, which are supposed to change the character of the transaction from that of donation into one of sale. The first condition provides that within one year from the date of the grant, the premises shall be fenced, and a house constructed thereon; the second, that the petitioner shall hold the premises subject to the existing municipal laws and regulations, and those which may be subsequently established; the third designates the penalty for non-fulfillment of the first condition, and the consequences of non-conformity with the second; and the fourth requires the payment of the municipal fees established by law. It is only upon the first and fourth conditions that the plaintiffs rely as giving character to the transaction.

"At the civil law, as at the common law, donations may be accompanied with conditions, the performance of which may be required for the possession or enjoyment of the property donated. Thus, as we observed in *Scott v. Ward,* a gift of fruits would not lose its character as a gift because accompanied with the condition that the donee should gather them; nor would a gift of land be less a donation because the beneficiary was required to measure off the specific quantity given, and to designate it by metes and bounds. When the donation is solicited for specific purposes, it may be accompanied with conditions limiting the property to such purposes without changing the character of the act, even when the conditions impose the discharge of expensive and burdensome duties. Thus, if one should solicit a gift of land in order that he might construct a church or college thereon, and the land should be granted on condition that such church or college be erected, the gift would be none the less a donation for the presence of the condition."

The United States Board of Tax Appeals based its opinion upon the case of *Jameson v. Shepardson, et al.*, 83 Cal. App. 596. In that case it appears that the plaintiff, in August, 1923, entered into a written contract with the Sierra Vista Lands, Inc., to purchase approximately ten acres of land and that on the 16th day of February, 1924, there remained due on the contract certain payments falling due in August of 1924, 1925, and 1926. The contract provided for forfeiture in case of default.

The plaintiff and the defendant, on the 16th day of February, 1924, entered into an agreement concerning the premises which provided, among other things, substantially as follows:

> " 'Whereas, said party of the first part (plaintiff) feels unable to carry on the business for which said property was purchased * * *;
>
> " 'Now therefore, it is mutually agreed * * * as follows:
>
> " 'The party of the first part (plaintiff) agrees to transfer and assign to the party of the second part (defendant) her interest under said contract, said assignment to be placed in escrow and to be delivered to the party of the second part on August 3rd, 1924, in the event that the covenants to be performed by the party of the second part are duly performed; said assignment shall be a gift by the party of the first part to the party of the second part, of the interest of the party of the first part under said contract and in and to said land'." (Parentheses ours.)

The agreement further provided that the defendant was to properly manage the property and the business and would render to plaintiff monthly statements showing the receipts and expenditures of the business.

The agreement between plaintiff and defendant also required the defendant to deposit in a bank not less than one-third of the gross receipts from the business and property to be held for the purpose of making payments under the purchase contract.

The agreement further reserved to the plaintiff a right to build a home on part of the land. The plaintiff brought action to recover possession of the property and to quiet title. The contention was made that the instrument constituted a gift and that, therefore, the plaintiff was entitled to have the contract complied with strictly, or according to the letter thereof.

The court held that under the circumstances the agreement was not a gift from the plaintiff to the defendant.

The foregoing case upon which the Board of Tax Appeals relied is in no way analogous to the case at bar for the facts show that there was a consideration. The facts in the *Jameson* case show that the defendant was required, prior to getting the assignment of the contract, to perform certain precedent conditions which constituted consideration. This is evident from the foregoing quotation. The obligations assumed by the defendant were conditions precedent to the acquisition of the title to the property; the title did not pass until the amounts required to be paid under the contract had been paid. This very definite requirement of the contract demonstrates that it was not the

intention of the plaintiff to make a gift. The court in its opinion stated, on page 602:

> "The paragraphs from the agreement entered into between the plaintiff and the defendant, Marin J. Shepardson, which we have last quoted, shows clearly the intent and purpose of the parties in providing for the deposit of the proceeds of the business in the Chowchilla Bank, to wit: The accumulation of a fund to be applied upon the payment coming due on August 3, 1924. That is the whole intent and purpose of the requirements set forth in the agreement concerning rendering of accounts and the deposit of money."

The fact that the defendant agreed to carry on the business was not deemed by the court to be essential. This was a condition subsequent.

The facts in the Jameson case are not in any wise comparable to the facts in the case at bar. We have already shown that the statements in the letter of W. A. Faris and R. M. Walker making the gift to Mr. Milliron and the statements in his letter to them regarding the assumption of obligations have at all times been dormant, except as to future obligations attaching to the ownership lease of the contractor. It has been demonstrated that W. A. Faris and R. M. Walker were not relieved of their obligations under the contract for lease. After the gift had been made W. A. Faris and R. M. Walker entered into a written instrument guaranteeing, until a building was completed, the faithful performance of the covenants of the contract; they also paid the $30,000.00 subsequent to the gift. Neither W. A. Faris nor R. M. Walker were actually relieved of their obligations under the contract for

lease. In the Jameson case the Sierra Vista Lands, Inc. consented to the assignment thereby recognizing that plaintiff was relieved of obligations under the contract and that defendant was liable therefor.

The only obligations that Mr. Milliron assumed were the subsequent obligations which in no manner represented consideration passing to W. A. Faris or R. M. Walker. The donee of any contract would naturally, by the acceptance thereof, be under obligations to take care of the burdens subsequently arising. The subsequent conditions, however, are not the kind of considerations that take the transaction out of the category of a gift.

A comparison of the facts in the case at bar with the facts in the Jameson case, it is most respectfully submitted, demonstrates that the last mentioned case has no application to the issue now presented before this Honorable Court.

(b) The Contract for Lease of November 1, 1920, Had a Fair Market Value on November 2, 1920, of $640,000.00, Which Amount Constitutes the Cost Thereof to C. J. Milliron.

As heretofore stated, Petitioner offered expert testimony with respect to the fair market value of the contract for lease dated November 1, 1920. Each one of the witnesses testified that it had the same fair market value on November 2, 1920 and January 2, 1921, as well as May 18, 1921 [R. pp. 143, 156, 162], and the Board of Tax Appeals on this evidence (which is uncontradicted) found as a fact that the fair market value of the agreement on January 2, 1921 and May 20, 1921 was $640,000.00.

[R. p. 58.] This is the value placed upon the agreement by the Petitioner when it acquired the agreement on May 18, 1921. [R. p. 198.] It is quite evident that the Board failed to find the same value of the agreement on November 2, 1920, merely because it had concluded that the acquisition of the agreement by Mr. Milliron did not constitute a gift. It would be illogical to assume that the Board would accept the testimony of these witnesses with respect to the value on January 2, 1921 and May 20, 1921 and reject the same testimony with respect to November 2, 1920.

The applicable revenue acts provide that where property is acquired by gift subsequent to December 31, 1920, the cost basis to the donee in case of sale or other disposition is the cost to the donor. The rule, however, was different with respect to gifts which were made prior to December 31, 1920. In gifts made prior to this date the donee's cost basis was the fair market value of the gift at the date acquired. Since C. J. Milliron acquired the gift prior to December 31, 1920, his cost basis was the fair market value thereof at the date acquired, to wit, November 2, 1920.

Petitioner, having acquired the agreement in exchange for substantially all of its stock, would be required to take as its cost basis, not only for the purpose of determining gain or loss, but also for the purpose of determining its invested capital, the cost basis of C. J. Milliron. In view of the fact that C. J. Milliron's cost basis for the agreement was $640,000.00 Petitioner is entitled to include that amount in its invested capital for the purpose of determining its excess profits taxes.

II.

Petitioner's Base for Determining Its Deduction for Amortization or Depreciation on Its Leasehold Interests Is $640,000.00.

The determination of this question depends upon the determination of the question in the two preceding subdivisions. If this court concludes that the cost basis to C. J. Milliron of the contract for lease was $640,000.00, then it would naturally follow that this would be the basis for determining Petitioner's deduction for the year 1926 for depreciation or amortization. [See Section 204(a)(8), Revenue Act of 1926, Appendix p. 41.]

III.

The Rentals Received by C. J. Milliron Prior to the Date of Petitioner's Incorporation and Prior to the Date of Its Acquisition of the Contract for Lease and During the Period From January 2, 1921, to May 18, 1921, Do Not Constitute Taxable Income to Petitioner.

C. J. Milliron, on January 2, 1921, made a lease to W. A. Faris and R. M. Walker, a copartnership doing business under the name of Fifth Street Store, which lease covered the property included in the agreement of November 1, 1920. The lease of January 2, 1921, provided for an annual rental of $150,000.00. [Ex. 6, R. p. 208.] There was received by Mr. Milliron under this lease from January 2, 1921 to May 18, 1921, the total sum of $56,-854.91 which was turned over to the corporation on May 18, 1921, when the corporation acquired the agreement of November 1, 1920. [Petitioner requested permission from the Board to prove this fact. R. p. 102.] The 99 year lease provided in the agreement of November 1, 1920, as

heretofore stated, was to commence on January 2, 1921, and because of this Petitioner acquired the benefits of the rentals from January 2, 1921.

Taxes are levied upon income received and certainly a corporation not in existence cannot be charged with having received taxable income. While the corporation did get the benefit of the rentals it received them only as contributed capital—the only possible way that it could receive them. This amount, therefore, would constitute part of Petitioner's invested capital for the year 1921 and would not in any wise constitute taxable income to Petitioner. This question was raised before the Board of Tax Appeals only after the Respondent had made a motion to disallow depreciation on the lease during the period from January 2, 1921 to May 18, 1921. The matter of raising this issue, however, is unimportant. The Supreme Court of the United States has held that a contention in a suit in equity should not be disregarded by a Circuit Court of Appeals on the ground that it was not raised in time, where it was clearly made before entry of the final decree below, and the adverse party does not appear to have been prejudiced in any way by the failure to make the exact contention earlier. (*Southern Pacific Co. v. Bogert,* 250 U. S. 483, 63 L. Ed. 1099.)

In *Griffiths v. Commissioner,* 50 Fed. (2d) 782, the court on review of the Board's decision remanded the case for further proceedings in the Board and thus directed that the record made by the Board in the first instance be reopened to introduce evidence regarding a waiver of the statute of limitations. The issue with respect to the waiver was raised for the first time in the Circuit Court of Appeals by the Government in the case on review.

Thus it would seem in the instant case that Petitioner was well within proper procedure in requesting reconsideration and reopening of its case to permit the record to be adjusted and the Board's decision amended in order to eliminate non-taxable income under the particular facts herein presented. The Respondent's motion and authorities in support thereof are contained in the record on pages 79 to 88. The Petitioner's motion requesting the elimination of the rents from Petitioner's taxable income appears in the record on pages 91 to 103.

The question to consider is whether a corporation is liable for tax on income received by an individual prior to its incorporation. The Board of Tax Appeals has held that this could not be done. See *Artemas Ward, Inc., Petitioner v. Commissioner of Internal Revenue,* 21 B. T. A. 1096. In this case the Commissioner of Internal Revenue attempted to tax a corporation on money received by its stockholder prior to the date of incorporation. The Board held that this could not be done and in its opinion stated:

> "* * * We know of no way, however, whereby Petitioner may be compelled to report and pay a tax on income it did not in fact receive, or, how it can now be estopped from showing what the true facts are."

See also:

Murphy Dillon Co., 23 B. T. A. 1320.

This is so self-evident that the citation of further authority is deemed unnecessary.

Since Petitioner filed an amended petition claiming this amount and since the uncontradicted evidence discloses that

the rentals could not possibly be income of Petitioner, it was error on the part of the Board of Tax Appeals not to exclude the rentals from Petitioner's net taxable income; it was also error on the part of the Board to fail to include the sum of $56,854.91 as part of Petitioner's invested capital. Section 326 of the Revenue Act of 1921 specifically provides that invested capital should include contributed capital.

In view of the foregoing, it is respectfully submitted that the decision of the United States Board of Tax Appeals should be reversed and that Petitioner's invested capital for the year 1921 should include the sum of $640,000.00 plus the sum of $56,854.91, that Petitioner's net taxable income for the year 1921 should be reduced by the sum of $56,854.91 and that Petitioner's base for determining amortization and depreciation on its leasehold interest for the year 1926 is $640,000.00.

Respectfully submitted,

THOMAS R. DEMPSEY,
A. CALDER MACKAY,
1104 Pacific Mutual Building,
Los Angeles, California,
Attorneys for Petitioner.

EDWARD S. BRASHEARS,
316 Investment Building,
Washington, D. C.;
CLARK J. MILLIRON,
GEORGE H. P. SHAW,
518 Fidelity Building,
Los Angeles, California,
Of Counsel for Petitioner.

APPENDIX.

Revenue Act of 1921:

"Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period."

"Sec. 325. (a) That as used in this title—

The term 'intangible property' means patents, copyrights, secret processes and formulae, good will, trademarks, trade-brands, franchises, and other like property;

"The term 'tangible property' means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

"The term 'borrowed capital' means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

"The term 'inadmissible assets' means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

"The term 'admissible assets' means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of section 326 and section 331.

"(b) For the purposes of this title the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares."

"Sec. 326. (a) That as used in this title the term 'invested capital' for any year means (except as provided in subdivision (b) and (c) of this section):

"(1) Actual cash *bona fide* paid in for stock or shares;

"(2) Actual cash value of tangible property, other than cash, *bona fide* paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided,* That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

"(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

"(4) Intangible property *bona fide* paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par

value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

"(5) Intangible property *bona fide* paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest; *Provided*, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable years; but

(b) As used in this title the term 'invested capital' does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

"(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall be the same fractional part of such average invested capital."

"Sec. 331. That in the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining

invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or reecived: *Provided,* That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation."

Revenue Act of 1926:

"Sec. 204. (a) The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * * * * * * *

(8) If the property (other than stock or securties in a corporation a party to a reorganization) was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of section 203 (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."